The Real Estate ANALYST

DECEMBER 20
1957

MORTGAGE BULLETIN

Volume XXVI

Number 57



Real Estate Economists, Appraisers and Counselors

# OUTLOOK FOR 1958

AS 1957 draws to a close, far-reaching and dramatic changes are occurring in the money market. After nearly three years of steadily rising interest rates, the oft-predicted shift toward easier credit is in full swing. Furthermore, the facts suggest that the trend is likely to continue well into 1958.

The striking reversal was signalled in mid-November, when the Federal Reserve Board lowered its rediscount rate from 3½% to 3%. Since then its progress has been astonishingly swift. To illustrate, at the peak of tight money (which, in retrospect, probably occurred some time in October), the rate on 91-day Treasury Bills stood at a 24-year high of 3.66%. By early December, in contrast, the Bill rate dropped below 3%. Similarly, yields on medium- and long-term Government bonds have declined from 3.50-3.60% to 3-3.25%; the return on mortgage bonds of top quality utility companies has dropped still more sharply. Rates on bankers' acceptances and commercial paper inevitably have followed suit, and, while the 4½% prime rate charged by commercial banks officially remains unchanged, pressure for a reduction is building up relentlessly.

The same forces also have begun to show up in the mortgage market, notably with respect to the offerings of the Federal National Mortgage Association. In October FNMA had to pay 4-7/8% on an eight-month Note. A fortnight ago, however, the agency readily sold a $100 million issue of ten-month debentures at a yield of 4.20%, and an equal amount of 7½-year obligations at only 4-3/8%. The latter issue, by the way, is the longest-term security which FNMA has offered to date, and now commands a premium in the market.

The abrupt turnabout in money rates, as noted, was triggered by the FRB. However, it is worth pointing out that signs of impending change were visible weeks before the Fed was moved to act. For one thing, in September an offering of long-term Treasury bonds, the 4s of 1969, was oversubscribed nearly tenfold. In the same month, rates on bankers' acceptances were whittled by 1/8%. Investor demand also proved surprisingly great for the aforementioned 4-7/8% FNMA Notes, which were doled out to would-be purchasers on the basis of 44% of their original subscription. Most significantly, in early November, while Washington still was keeping a tight rein on credit, Treasury Bills declined from 3.66% to less than 3.45%.

What the market was reflecting in early autumn was the growing recession in business activity. Today signs of the setback may be seen on every hand, in the spheres of credit, production, employment, and sales. Since July, instead of expanding in line with seasonal expectations, commercial, industrial, and farm loans actually have declined. As to the movement of goods to market, steel mills currently are operating at less than 70% of capacity and freight carloadings are trailing more than 15% behind the like 1956 period. Sales of soft goods and hard goods alike - in particular, the 1958 model cars - have been disappointing. Unemployment in November rose to 3.2 million, highest for the month since 1949, and plainly a harbinger of worse to come.

In short, the outlook for interest rates in the coming year will depend less upon what may be done in Washington than upon the state of the economy. This point was underscored the other day by Edward E. Brown, board chairman of the First National Bank of Chicago. Commented Mr. Brown: "By open market operations or reducing reserve requirements, the FRB may slightly hasten the time of a decrease in interest rates. But the decisive factor determining interest rates during the next six or seven months will be the development of the business picture." As to that key question, the Chicago banker observed: "The U. S. and most other countries of the world are now in a mild recession. No one can say with certainty how long it will last before it turns or how much deeper it may go."

To be sure, there is no lack of opinions, bullish and bearish alike, regarding the business outlook. Several of particular interest to mortgage lenders may be cited. For example, according to experts of the U. S. Savings and Loan League, 1958 will be a year of economic stability, distinguished by neither a rapid expansion nor a serious decline. The Prudential Insurance Company of America sums up its economic views in the words "further hesitation and then a brisk advance."

According to its forecast, business activity will remain at present levels for the next few months, as manufacturers' inventories are worked off. Some time around midyear, both business and consumer outlays will start climbing again, reinforcing the steady rise in Government spending. Hence, says Prudential, the second half of 1958 is likely to be strong, with gross national product for the full year approaching $450 billion, an increase of around $13 billion over the estimated total for 1957.

Other qualified observers, however, are less hopeful. Last weekend, the economist for the U. S. Chamber of Commerce stated that the current slackening in business "is likely to be at least as severe as the recessions of 1949 and 1954." The number of jobless, he went on to say, in coming months easily may rise to 4-5 million or even more. As to the probable duration of the setback, virtually everyone is talking of recovery by the next year-end. However, at least one housing expert demurs. He looks for an "interim period," or lag, lasting for at least two years and perhaps as long as five.

On this score, one cannot be dogmatic. However, the facts suggest that the current business decline well may be more protracted and painful than most people expect. With but one or two brief setbacks, after all, the U. S. has enjoyed twelve years of inflation-fed prosperity. Unless - as some profess to believe - the cycle has been wholly eliminated from the U. S. scene, a downturn of some dimensions is, if anything, overdue.

This theoretical argument is reinforced by several highly factual ones. Trade and manufacturing inventories, after rising to an unprecedented peak of $91.3 billion at the end of September, have begun to decline. In October alone, they fell $300 million, a substantial cutback indeed. At the same time, outlays for new plant and equipment, another key economic barometer, are slackening. In the first three months of 1958, according to official forecasts, such spending will be down 5% from the comparable quarter of 1957. For the year as a whole, it would not be surprising if the drop amounted to more than 10%, or some $4 billion. In the circumstances, neither Government nor consumer spending is likely to rise rapidly enough to take up the slack.

The foregoing observations point to one major conclusion for the mortgage lender. In 1958, fixed income obligations are likely to grow increasingly attractive, perhaps at an unexpectedly rapid rate. Indeed, the speed of the rise to date has been eye-opening. Long-term Treasury bonds are a case in point. In the four weeks after the cut in the rediscount rate, the 3-1/4s of 1983 soared from 94 nearly to par. This rapid advance has run far ahead of the rate of rise achieved in 1953, at the start of the last business recession. In that year it took the 3-1/4s six months - from the June low to the end of December - to advance by only one point more. Similarly, not since the bank holiday of 1933 has so precipitate a decline occurred in yields on high-grade corporates. Thus, in the week ended December 13, the return on Barron's ten highest-grade bonds dropped from 4.04% to 3.89%, one of the sharpest market movements in U. S. financial annals.

True, this pace cannot long be maintained. Indeed, at this writing signs of a temporary check in the upsurge of bond prices may be observed. Bank lending, largely for tax purposes, right now is at a seasonal peak. Moreover, the Treasury not long ago announced plans to increase its weekly Bill offering by $100 million in order to raise new cash. Nonetheless, once such temporary market factors are out of the way, the drop in yields in all likelihood will resume.

Nor will the impact on mortgages be long delayed. In fact, here and there throughout the country it already is being felt. Last week one mortgage firm in Chicago revealed that for the first time in months it had received two firm bids for mortgages totaling $4 million. A savings banker in New York City reports some shading of mortgage rates. Similar reports have come from lenders and builders in Dallas and Philadelphia.

Again, a comparison with 1953 may be fruitful. In that year, according to Harry Held, vice president of the Bowery Savings Bank of New York, yields on mortgages began to be affected appreciably by the end of the year. By August of 1954, rates on conventional home loans had declined up to 1/2%. This time, for several reasons, the adjustment in yields may be faster.

First, with housing starts off sharply, the free supply of home loans - particularly U. S.-insured and guaranteed paper - has shrunk drastically. As one knowledgeable mortgage banker put it not long ago, "As compared with a year ago, or even six months ago, there is no large amount of VA or FHA mortgages overhanging the market." Moreover, owing to the fixed rate of 4½%, the VA program is approaching a state of collapse; at the same time, FHA has been hampered seriously - perhaps hamstrung - by the controls imposed by Congress over discounts, commitment fees and the like, as well as the red tape now involved in such transactions. Hence, unless Fanny Mae should resume liquidating its portfolio on a massive scale, the amount of such paper is unlikely to increase appreciably next year.

The same is true of the supply of corporate and municipal bonds. In 1957 local and State governments offered nearly $7 billion of obligations, close to the all-time high. At the end of November, however, backlogs of postponed issues were dropping and voters had authorized a relatively small total of new ones. By the same token, with industrial expansion past its peak, U. S. corporations are likely to be less eager borrowers. Hence in 1958 both municipal and corporate offerings are apt to decline.

One Government bond dealer recently described the current and prospective state of the money market in the following provocative terms: "Treasury Bills in January should adjust to sell around 2-3/4%. The one-year rate for the Treasury might not be higher than 2-7/8%. The five-year Treasury yield should be around 3 - 3-1/8%; long-term 3-1/4% bonds could sell at par. Against even present Treasury yields, corporates and municipals seem cheap, so the future adjustment in that sector of the capital market may be even greater. . ."

In sum, lenders would do well to prepare for a further - and perhaps sharp - decline in money rates. They also should expect some increase in delinquencies and foreclosures. As one prominent savings banker observed last week, today is a highly appropriate time to review mortgage portfolios and investment policies.